**Franchise Tax Board**

# ANALYSIS OF AMENDED BILL

| | | | | | |
|---|---|---|---|---|---|
| Author: | Costa | Analyst: | Norm Catelli | Bill Number: | SB 1123 |
| Related Bills: | See Legislative History | Telephone: | 845-5117 | Amended Date: | 05/02/2001 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Manufacturers' Investment Credit Allowed to Lessor of Qualified Property if Lessee Agrees

## SUMMARY

This bill would allow a lessor to claim the Manufacturers' Investment Credit (MIC) if specified conditions are met.

## SUMMARY OF AMENDMENTS

The May 2, 2001, amendments would:

- Expand the election to taxpayers subject to the Personal Income Tax Law (PITL),
- Phase in the MIC percentage available to a lessor over three years,
- Resolve implementation concerns discussed with the author's staff, and
- Change the operative date from January 1, 2001 to January 1, 2002.

## PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to allow lessors and lessees to negotiate for the ability to claim the MIC.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and specific language would make the bill operative for taxable years beginning on or after January 1, 2002.

## POSITION

Pending.

## ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business and allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or for investment property.

| Board Position: | | | Department Director | Date |
|---|---|---|---|---|
| ____ S | ____ NA | ____ NP | Alan Hunter for GHG | 05/22/01 |
| ____ SA | ____ O | ____ NAR | | |
| ____ N | ____ OUA | X PENDING | | |

Existing federal law does not have a credit comparable to the MIC.

Existing state law allows qualified taxpayers a credit, known as the MIC, equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating, or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) For certain taxpayers engaged in specified SIC Code activities, special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

The MIC is allowed for qualified property leased by a qualified taxpayer. The MIC is not allowed to the lessor of the property, regardless of whether the lessor is a qualified taxpayer.

THIS BILL

Under the PITL and the Bank and Corporation Tax Law (B&CTL), for taxable years beginning on or after January 1, 2002, this bill would:

- Allow the lessor of qualified property to claim the MIC if the lessee elects to allow the lessor to claim the MIC, and,
- Phase in over three years the MIC percentage available to a lessor. For 2002, the percentage would be 2%; for 2003, the percentage would be 4%; for years after 2003, the percentage would be the percentage then applicable to the MIC.

**LEGISLATIVE HISTORY**

SB 671 (Alquist, Ch. 881, Stats. 1993) added the MIC to the Revenue and Taxation Code.

SB 676 (Alquist, Ch. 751, Stats. 1994) made clarifying changes to the MIC, and added provisions allowing the credit for leased property. SB 676 specifically limited the MIC to the lessee.

**OTHER STATES' INFORMATION**

The *Massachusetts*, *Michigan* and *New York* investment tax credits are not allowed for leased property. The laws of these states were reviewed because they have credits comparable to the MIC.

**FISCAL IMPACT**

Implementing this bill would require some changes to existing tax forms and instructions and audit procedures, which could be accomplished during the normal annual update.

**ECONOMIC IMPACT**

Revenue Estimate

Based on the discussion below, the revenue loss from this proposal is as follows:

| Revenue Impact of SB 1123<br>Beginning on or after January 1, 2002<br>Enactment after June 30, 2001<br>Fiscal Year Impact<br>(In Millions) | | | |
|---|---|---|---|
| 2001-02 | 2002-03 | 2003-04 | 2004-05 |
| -$5 | -$15 | -$25 | -$20 |

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion:

This estimate is based on a 1992 survey of industry activity by the Equipment Leasing Association of America and the micro simulation model of California tax returns for tax year 1998. These numbers were grown to approximate 2001 and beyond. According to the survey, lease financing represents approximately 32% of all business investment in equipment. For this analysis it was assumed approximately one third of unapplied MIC credits would pass through to the lessor and that virtually all of the transferred credits would be used in the year transferred. Since unapplied credits under current law can be carried over and used in subsequent years, the net impact of this bill decreases over time.

**ARGUMENTS/POLICY CONCERNS**

When clarifying issues regarding the MIC in SB 676 (Alquist, Ch. 751, Stats. 1994), the Legislature at that time added lessees under operating ("true") leases, and not “financial” leases, to the class of taxpayers that could claim the MIC, but specifically precluded lessors from claiming the credit for property leased to manufacturing businesses.

Proponents of this bill believe that the credit should be allowed to the lessor if the lessee agrees because there are cases where the lessee’s tax liability is not sufficient to use the MIC, even with the available 8 or 10-year carryover period. Further, proponents argue that lessors contribute to growth in the manufacturing industry in California by providing an alternative financing mechanism to manufacturers to acquire property otherwise qualifying for the MIC.

Equipment finance leasing has long been a component of numerous tax shelter schemes. This bill makes no distinction between true leases and finance leases. As a result, a finance lessor who is a mere lender of money for tax purposes is eligible for the credit even though he is not the owner of the qualified property for tax purposes (i.e., does not bear the risk of economic loss).

**LEGISLATIVE STAFF CONTACT**

| | |
|---|---|
| Norm Catelli | Brian Putler |
| Franchise Tax Board | Franchise Tax Board |
| 845-5117 | 845-6333 |